

Egypt and the Partnership Agreement with the EU: The Road to Maximum Benefits

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Abstract

The Agreement under negotiation between Egypt and the EU will affect the industrial sector and the rest of the Egyptian Economy in a significant way. It will entail phasing out tariffs on Egyptian imports from the EU-form which Egypt imports about half of its total inports-to zero over a 12-year period. The paper explores the nature and magnitude of the agreement's impact on the agreement by using it as one component of a coherent growth strategy. It further outlines the key elements of a strategy that aims to achieve a sustainable growth rate of 7 percent per annum.

ملخـــــص

سيكون لإتفاقية المشاركة المصرية – الأوروبية، التى يجرى التفاوض بشأنها، أثار واضحة على القطاع الصناعى وعلى سائر الاقتصاد المصرى. فستنطوى هذه الإتفاقية على تخفيض تدريجى للرسوم الجمركية المفروضة على الواردات من أوروبا، والتى تمثل نصف ما تستورده مصر من العالم الخارجى، حتى تصل إلى الصفر فى غضون إثنى عشر عاما. وتستكشف هذه الدراسة طبيعة وحجم التأثير الناجم عن هذه الإتفاقية على الإقتصاد المصرى، وتناقش الكيفية التى يمكن بها تعظيم المنافع من هذه الإتفاقية، عن طريق إستخدامها كواحد من مكونات إستراتيجية متسقة للنمو الإقتصادى. كما تقوم الدراسة أيضا بتحديد العناصر الأساسية لهذه الإستراتيجية التى تستهدف نموا اقتصاديا مطردا بمعدل لا يقل عن ٧% فى العام

I. Introduction

Paul Krugman has repeatedly made a very simple, important, yet often ignored point: magnitudes matter. Trade matters for employment and growth only if it accounts for a large percent of GDP. The larger the percentage, the greater the dependency of the economy on its trading partners. Krugman used this argument forcefully to criticize such well-known authors as Thurow, who blamed Japan's restrictive trade policies, in his book *Head to Head* (1992), for the loss of American jobs. In 1993, the US only imported 11.4 percent of its GDP, and exported 10.4 percent; total imports from Japan equaled only 1.7 percent of GDP.

Applying Krugman's point to the Egypt-EU partnership agreement leads to the conclusion that it may make an important difference to growth and employment in Egypt. Exports plus imports were $17.5 billion in 1994—or 35 percent of GDP. The 15 EU countries alone receive 50 percent of Egypt's exports, and some 40 percent of all imports originate in the EU. The agreement will entail dramatic changes in the degree to which the Egyptian economy is open to competition from EU countries, as Egypt will cut its tariffs on industrial imports from the EU to zero.[1] More fundamentally perhaps, Egypt is neither as developed nor free market-based as the US, which means that there is a premium on actions that foster integration into the world economy and signal the government's commitment to market-oriented reforms.

Given that the benefits of an agreement are largely endogenous, policy makers can make a big difference to the final outcome. We argue in this paper that the partnership will be most beneficial to Egypt if it is part of a coherent growth strategy. To develop this argument, we first set the stage by comparing Egypt's current economic growth strategy with the fast-growing economies. In section III we explore how the partnership can enhance economic growth in Egypt. Section IV discusses the implications of the agreement for different sectors. Finally, in Section V we highlight the domestic reforms necessary to enable Egypt to take full advantage of the agreement.

II. Is Egypt Ready to Take Off?

Although Egypt's GDP growth rate has picked up in the last couple of years, per capita GDP has in fact declined by 3 percent a year over the period 1990-95. For Egypt to raise the standard of living of a population growing at about 2 percent a year and to begin catching up with higher income countries, it must grow by at least 7 percent per year for a sustained period of time.

II.1 What does it generally take to grow fast?

There is consensus that growth comes primarily from three sources: (1) the accumulation of human and physical capital; (2) the efficient allocation of resources; and (3) productivity improvement. However, there is no consensus on how to realize these components of growth. The debate still rages, for example, over the extent to which resources should be allocated by markets as opposed to guided by government policy; how efficient governments are in picking winners; and the choice of policies to foster savings, investment and innovation. Searching for a growth strategy amounts in the final analysis to selecting appropriate economic institutions that support growth.

Broadly speaking, the evidence overwhelmingly discredits large-scale import substitution policies, large government, and central planning as effective strategies for economic growth. The collapse of the Soviet Union and the success of the export-oriented South-east Asian countries provides strong backing to this view. Evidence from cross-country growth regressions (e.g., Barro, 1991; and Levine and Renelt, 1992) suggests that two sets of variables are strongly associated with growth: factors reflecting initial conditions (e.g., per capita GDP, secondary school enrollment, income distribution, etc.), and policy variables (e.g., inflation, financial market development, etc.). This literature also supports the view that institutions matter, as measured by political stability, civil liberties and contract enforcement. Indeed, North has concluded that "the inability of societies to develop effective, low-cost enforcement of contracts is the most important source of both historical stagnation and contemporary underdevelopment in the Third World" (1990, p. 54). Knack and Keefer (forthcoming), among others, find that property rights (measured by evaluations of contract enforceability, rule of law, and risk of expropriation) have a significant impact on investment and growth. Surveying the literature, Rodrik (1996) notes that

[1] In contrast, under its commitments made in the WTO context, Egypt will not be obliged to change its current tariff regime at all. The average rate at which tariffs have been bound in the GATT is some 5 percentage points

equality also matters for growth through its impact on governance. Better governance follows from more egalitarian regimes because governments become less needy politically of redistributive policies for survival; they receive less lobbying pressure from different interest groups; and they have more time and greater incentives to ensure that the civil service is efficient in providing public goods (as opposed to imposing red tape and engaging in rent-seeking activities).

Finally, part of the literature dealing with growth-enhancing factors compares successful and unsuccessful country cases. One example of this literature is Sachs and Warner (1995), who found that the fastest-growing economies in the developing world were more open than those that did not grow as fast. Comparing Chile with the rest of Latin America, Büchi (1996) argues that Chile's success story can be attributed to three factors: stability (i.e., low inflation), structural changes (consistent with higher domestic savings and exports, more competition, and smaller government), and social programs to help the very poor.

The literature attempting to account for growth is extensive, and we do not intend a comprehensive review here. But the evidence is abundantly clear that beyond the initial conditions in a given country, policies matter.[٢] Policies can foster the accumulation of capital, improve the allocation of resources, and contribute to productivity growth. Our reading of the literature and empirical evidence suggests that the key to the accumulation of physical and human capital is savings, domestic and foreign. The key to the efficient allocation of resources is openness of the economy to trade and financial flows. And the key to productivity improvement is competition (domestic and international), private ownership and the acquisition of technology.

Savings, openness and competition are associated with other variables. Some of these relationships are highlighted below.

Savings and size of government. Large government expenditures correlate negatively with public savings (see Sachs, 1996). This is because large expenditures mean high marginal tax rates, which encourage tax evasion/avoidance, or monetary expansion with resulting macro-economic instability. To mobilize savings and foster more rapid growth, the size of the government should not be too large. Lower government expenditures imply lower marginal tax rates on corporations and personal income.

above the 1994 applied tariffs (Subramanian, 1995).

Low tax rates induce investment, especially if designed in a non-distortionary fashion to encourage reinvestment of retained earnings. As important, with respect to expenditures, the evidence suggests that net social returns are much higher when resources are used to finance basic infrastructure, health and primary education, as opposed to the maintenance of a large civil service, welfare spending, or subsidization of certain sectors (through the budget or through protection). Redistributive transfers are generally negatively correlated with growth. An important source of savings by individuals is for retirement. To motivate individuals to save, governments should give up generous pay-as-you-go state pension systems, if applicable. One example where this reform has been successfully implemented with positive implications on savings is in Chile (see Büchi, 1996, for details).

Smaller government, shifting expenditure away from redistributive transfers, and reforming pension systems are all policies that will increase savings. Provided there are incentives and channels to transform these savings into productive investment, this will stimulate growth. The accumulation of physical and human capital is the surest way to grow fast, as Krugman (1994) has argued in his widely-read article.

Openness of the economy and manufactured exports. Open economies tend to export more manufactured goods than less open economies, and are better at attracting and using technology (Sachs and Warner, 1995; Page and Underwood, 1996). Openness is generally interpreted to include currency convertibility, low import tariffs for intermediate inputs and machinery, and the absence of nontariff barriers and taxation on exports (including duty free access to imports). Conversely, where the currency is overvalued, inflexible and/or nonconvertible, where tariffs on intermediate inputs and machinery are high, and where exports are taxed heavily (because of import barriers and transaction-increasing costs), potential exporters find it more attractive to produce for domestic markets. The end result is a slow-growing economy, which is less efficient and dynamic than it might be otherwise.

How do openness and manufactured exports contribute to growth? The arguments, which are backed by empirical evidence, are straightforward. The key is competition, both from imports and export markets. This brings about more efficient allocation of

[٢] Of course, some initial conditions are reflections of past policies, e.g., human capital, income distribution, etc.

resources and total factor productivity (TFP) growth through specialization, learning by doing, exploitation of economies of scale, and attracting new technology.

Competition and private sector-led growth. Openness is the shortest route to enhance competition, especially in the tradable sectors. Equally important, however, is the extent to which the economy is dominated by state-owned enterprises (SOEs). The greater the role of SOEs, the less competition will generally prevail in domestic markets. Governments typically carve out markets for SOEs by granting monopoly rights, imposing high trade barriers, providing access to capital that may not otherwise be available on commercial grounds, and assuring labor returns above the value of marginal product. Frequently, SOEs are large in size to the point of dominating their markets, even where they do not enjoy any formal monopoly rights.

For these reasons, privatization (combined with openness) is critical not only to improve productivity and increase investment, but also to increase competition. The gains in growth from privatization can be very substantial. Assuming SOEs account for 10 percent of GDP, privatizing just one half of the SOE sector can generate as much as a 1 percent increase in GDP (Galal and others, 1994).[3] A corollary of privatization is the associated change in the nature of the role of government. Instead of acting as an entrepreneur and owner of resources, its role shifts to a regulator to protect the consumers and the needy, enforce contracts and protect the functioning of markets. As noted below, improving the performance of the government in these areas is particularly important in the Egyptian context.

II.2 How does Egypt compare with fast-growing economies?

Egypt has undertaken substantial reforms in the 1990s. The budget deficit was reduced sharply, the growth of money supply curtailed, the exchange rate devalued and unified, and the capital account liberalized. Interest rates were freed and treasury bill auctions used to manage liquidity. Simultaneously, foreign trade was liberalized by virtually removing all quantitative restrictions on imports and reducing and rationalizing import tariffs. With a few exceptions, the maximum tariff was reduced from 160 percent in 1988 to 70 percent in 1994. In December 1993, the marginal tax

[3] In a country like Egypt, where the size of the SOE sector relative to GDP is about 33 percent, the magnitude of the gains from privatization is likely to be even more significant. For a recent analysis of the impact of SOEs on the economy, see World Bank (1995d).

rate was reduced from 65 to 48 percent, corporate dividends exempted to avoid double taxation, and the corporate tax rate lowered to 42 percent (with a further reduction to 34 percent for manufacturing). Inflation declined from 20 percent in 1990 to 8.3 percent in 1995. The current account deficit, excluding official transfers, declined from 6.8 percent of GDP in 1990 to 2.0 percent in 1995. International reserves increased to about $18 billion (18 months of merchandise imports) in 1995, thanks to a significant inflow of private capital. The success of the stabilization program was helped by debt forgiveness received in the wake of the Gulf War.

Notwithstanding this progress, per capita GNP growth averaged 2.8 percent per year between 1980-93, compared to 5.3 percent for fast-growing Southeast Asian economies. This modest growth was essentially wiped out by population growth, leading to stagnation in the standard of living. Unemployment is relatively high (reaching 9.6 percent in 1995); investment is modest; and merchandise exports have in fact declined on average in the last few years, and remained less diversified than desirable (see Table 1).[٤]

Egypt's lackluster growth performance relative to Southeast Asian economies reflects a much lower savings rate and significantly greater government expenditures, much of which does not go into infrastructure and similar public goods. Egypt's tariff rate is also much higher. Despite the liberalization program mentioned earlier, the average tariff fell only marginally (from 31 percent in 1988 to 28 percent in 1994).

Table 1. Selected Economic Indicators, 1989-95

[٤] Although a significant change has occurred in Egypt's composition of exports since the 1960s (cotton used to account for almost 50 percent of total exports, compared to some 4 percent currently), diversification and growth in nontraditional exports has lagged behind. According to UN statistics, Egypt's total merchandise exports in 1994 were $5.5 billion, of which some 50 percent went to European countries. Some 50 percent of Egypt's exports are comprised of oil and oil products. Agriculture/food accounts for another 5 percent. Manufactures represent only one-third of total merchandise exports. Exports of manufactures have been expanding—high growth items in recent years include aluminum, clothing, iron/steel, chemicals and furniture (Yeats, 1996). For most industries, however, the value of goods shipped abroad accounts for less than 0.5 percent of total exports. This is the case for 75 percent of the 2-digit categories of the Standard International Trade Classification. Given the diversified industrial base that exists in Egypt, this weak export performance illustrates both the need for efficiency-enhancing

	1989	1990	1991	1992	1993	1994	1995	Average 1989-94
Real GDP growth rate (%)	3.0	2.4	2.1	0.3	0.5	2.0	2.4	1.8
Real GDP per capita growth rate (%)	0.0	-0.6	-0.4	-1.4	-1.7	0.0	0.4	-0.5
Inflation (%)	16.7	17.5	22.4	19.4	10.4	8.2	8.3	14.7
Unemployment (% of labor force)	7.0	7.6	8.4	9.2	10.1	9.8	9.6	8.8
Investment (constant 1992 LE bil.)	24.5	24.2	23.1	20.8	21.0	22.6	22.8	22.7
Investment (% growth rate)	0.0	-0.9	-4.6	-9.8	1.5	4.5	1.0	-1.2
Merchandise exports (US$ bil, 1992=100)	3.0	3.1	3.7	3.6	3.5	3.2	3.3	3.3
Exports growth rate (%, 1992 prices)	-17.8	5.1	19.7	-2.4	-2.9	-10.2	4.7	-0.6

Source: World Bank.

The average collection rate (that is, trade taxes as a share of merchandise imports) is 50 to 100 percent higher in Egypt than in the comparator countries. SOEs account for a much larger portion of GDP in Egypt than in Southeast Asia, and the rate of growth of manufactured exports is much lower (Table 2).

A convenient way of summarizing the relative performance of the Egyptian economy is the efficiency index compiled by the Harvard Institute for International Development and the World Economic Forum for a sample of 49 countries. The index is the sum of three measures: openness of the economy to trade and financial flows; the size of government in the economy; and labor market flexibility. It gives a higher score for more openness, smaller government (measured by government expenditure to GDP, and various rates of taxation), and more flexible labor markets. According to this index, Egypt ranks 22nd on openness, 31st on size of government, and 40th on flexibility of labor markets (Sachs, 1996).

Perhaps more worrisome than the fact that Egypt is still a substantially closed economy compared with dynamic exporting countries is that the economy has become less integrated since the early 1980s. The change in openness (as measured by the ratio

reforms and the potential that exists for expanding exports significantly once Egyptian enterprises begin to confront greater international competition.

Table 2. Selected Indicators of Egypt and Fast-Growing Economies
(Percent of GDP)

Country	Gross domestic savings 1993	Government spending 1995	Average tariff rate 1993(1)	Growth of manufactured exports 1985-92	Change in trade to GDP ratio 1980-83 to 1990-93	Average share of SOEs/GDP 1978-91
Chile	24.0	20.8	9.5	26.3	1.0	12.0
Hong Kong	31.0	16.6	0.0	21.4	19.1	na
Indonesia	31.0	17.1	5.0	33.2	-1.4	13.0
Korea	35.0	20.3	4.0	14.1	1.4	10.2
Malaysia	28.0	30.6	6.0	29.2	5.7	na
Singapore	47.0	20.4	0.4	20.2	11.1	na
Thailand	36.0	22.1	9.0	33.7	3.3	5.4
Egypt	18.0(2)	36.5	15.0	1.0(3)	-1.9	32.8

Sources: World Bank, *World Development Report*, 1980, 1982 and 1995; *Government Finance Statistics Yearbook* IMF, 1994;
UNCTAD Trade Analysis and Information System data, 1995; and World Bank, *Global Economic Prospects*, 1996.
(1) These are calculated as collected taxes on trade as a share of total merchandise imports.
(2) Gross national savings for 1993, as estimated by the World Bank. Gross domestic savings were only 6 percent of GDP.
(3) Annual average growth over the period 1986-1994.

of population-adjusted trade to GDP) that occurred in the last decade was negative (Table 2), as compared to the increase that occurred in the majority of comparator countries.

The openness of an economy to international trade can also be measured by the level of trade barriers. On this basis, Egypt is also lagging behind comparators. Particularly noteworthy in this connection is that tariffs on raw materials and machinery are significant (some 10 percent on an import-weighted basis). The average nominal tariff on all imports in Egypt is currently about 30 percent. Although collected tariff revenue is substantially less (around 15 percent) because of exemptions, duty drawback and related policies, the use of such mechanisms gives rise to red tape costs and raises the dispersion of protection across firms and industries. Moreover, tariffs are complemented by a wide variety of other trade barriers.

Finally, the Egyptian economy is perceived to be overregulated, and contract enforcement is considered weak. According to a World Bank study (1995c), the perception of the administration of justice is that the system is simply too slow, expensive, and uncertain. In 1993/94, the clearance rate of commercial cases was only 36 percent, compared with 80 percent in Japan, and 88 percent in Belgium. A survey of private firms revealed that the most binding institutional constraints on private

sector operation and investment were policy uncertainty, tax administration, access to finance, access to intermediate inputs, and labor regulation, in that order (Galal, 1996). Reducing policy uncertainty and the burden of tax administration and improving contract enforcement are therefore key elements to stimulate growth.

There is clearly much scope for improvement in policies. Against this background, it is useful to assess how an association agreement between Egypt and the EU will help relax some of these constraints, provide a step toward global integration, and signal government commitment to reform. In our view, the EU partnership should be viewed as a tool and component of a growth strategy that will help put Egypt on a sustained high growth path.

III. The Partnership Agreement and Growth

Given the foregoing, in our assessment of the partnership agreement we focus on three growth-related "integration" variables: trade openness, investment, and domestic competition. In each case, we identify the changes likely to be brought about by the agreement, and the implications of these changes for the Egyptian economy.

III.1 Trade

To what extent will the partnership agreement change the trade regime, giving industries access to lower-cost inputs and consumers access to lower-cost goods? With respect to tariffs, the agreement will enable enterprises to source inputs and machinery free of duty and to confront greater competition from EU sources. This will encourage investment and improvements in productivity. As far as nontariff barriers are concerned, UNCTAD estimates that these apply to some 25 percent of imports of capital goods and raw materials (Lee, 1993). In practice, nontariff barriers are mainly product standards (quality control) and various customs-related practices (valuation, classification, cumbersome procedures and "red tape"). Some of these will be eliminated or reduced as a result of the implementation of the agreement. But the magnitude of the reductions depends importantly on the vigor with which this is pursued.

Quantifying the impact on the Egyptian economy of reducing trade barriers is difficult, as many effects are not readily measurable. The economic impact of preferential liberalization is conventionally broken down into two types—static and dynamic. The static impact is determined by the effect on allocation of existing

resources; the dynamic effect takes into account the impact on the rate of factor accumulation (investment). The static welfare impact of trade liberalization is generally relatively small, because the efficiency gains that result from bringing domestic prices closer in line with world prices are offset by the loss in tariff revenue. Its magnitude depends on numerous variables, including the structure of domestic markets before opening the economy and the existence of economies of scale in production. The greater the market power of domestic firms and the less competition that prevails, the greater the increase in welfare resulting from liberalization. Much also depends on the type of trade barriers that are removed. Although all barriers raise the domestic price of goods above world levels, some trade barriers are sources of real resource costs that benefit no industry (e.g., inspection requirements and time-consuming customs procedures). Other barriers create rents for specific interest groups and therefore represent a transfer of income within society. For this reason, the net welfare gains from removing trade barriers involving real resource costs tend to be larger than from rent-creating barriers such as tariffs or quotas.[°]

The empirical evidence on Egypt's trade regime concludes that the prevalence of administrative barriers is significant (World Bank, 1995c). A recent study by Konan and Maskus (1996) of the static effects of preferential liberalization vis-à-vis the EU suggests that much of the welfare gain from a partnership agreement may be associated with a reduction in administrative barriers. Free trade with the EU—elimination of tariffs on EU imports combined with an assumed 1 percent increase in prices of Egyptian exports because of reduced incidence of testing and certification costs in the EU, as well as an 8 percent increase in export prices of agricultural produce and clothing—results in a welfare gain of only 0.2 percent of GDP. If it is assumed that the partnership agreement also reduces administrative costs incurred by

[°] Note that some administrative barriers may not differentiate between sources of imports. If these barriers are reduced or removed in the context of the partnership agreement, they will also reduce the costs of trade with non-EU countries. This will further increase the gains from the agreement.

traders—due to customs procedures, quality control, "red tape"—the welfare gains rise to 1.8 percent of GDP.[٦]

A key issue, therefore, is lowering trade-related transaction costs. The partnership agreement will help achieve this to some extent, because it will involve some harmonization of regulatory regimes and administrative requirements relating to product standards, testing and certification procedures, and common documents for customs clearance (e.g., the EU's Single Administrative Document). The negotiation of mutual recognition agreements (e.g., for inspection and certification of goods), and coordination and cooperation on a wide variety of regulatory issues, are objectives of the agreement. To what extent these objectives will be achieved depends on the vigor with which they are pursued, and the extent to which the necessary institutions are created and/or restructured and upgraded.

The preferential nature of the trade liberalization that will be undertaken under the partnership agreement will lead to trade creation (replacement of domestic production with imports from the EU) and trade diversion (replacement of imports from outside the EU with European goods). Both of these effects imply that the EU share in Egypt's trade in manufacturing will expand. How much the EU's import market share will become depends on a number of factors, such as demand elasticities and domestic supply response. Konan and Maskus (1996) estimate that in the short run the volume of imports and exports will rise by some 20 and 30 percent respectively (no allowance being made for inter-sectoral reallocation of capital) and 30 and 40 percent in the long run (allowing for capital reallocation). These estimates do not allow for any dynamic effects. Insofar as investment is encouraged, trade flows will expand more.

III.2 Investment

Fostering greater investment, including foreign direct investment (FDI), is a major objective of the Egyptian government. Inducing the repatriation of Egyptian capital abroad—estimated at $60-80 billion—is considered key for attracting investment from non-Egyptian sources (Bayoumi 1996). Attracting FDI is important because it is a source of know-how and technology, creates employment, and fosters trade. The

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[٦] The simulation uses a 38-sector computable general equilibrium model of the Egyptian economy. The assumed 8% increase in agricultural export prices presumes that better access will be obtained for such goods, and may be somewhat optimistic. It is assumed that administrative barriers impose costs equivalent to a 5% tax on imports of goods, a 10% tax on exports, and a 15% tax on imported or exported services. These figures are conservative.

investment to GDP ratio is currently 17 percent, significantly below that of dynamic export-oriented countries, which often have double this figure or more. Moreover, FDI in Egypt is negligible compared to the flows going to emerging market economies. Measures of investor confidence (*Institutional Investor* country ratings) and the change in the ratio of FDI to GDP illustrate the problem. Investor ratings for Egypt were already relatively low in the early 1980s, and have declined since then (Table 3). Although in comparison to other countries the magnitude of inward FDI flows has been above average, the trend has been declining. Moreover, very little FDI has gone into export-oriented manufacturing activities.

Whether greater investment will be induced by the partnership agreement is an important—indeed, a crucial—question. Liberalization of trade under a partnership agreement may generate a number of beneficial dynamic effects. One is the indirect effect of the static allocative efficiency gain. For the given initial stocks of labor and capital, the increase in income following liberalization increases per capita savings, which in turn gives rise to greater investment (Baldwin, 1994). Investment may also be stimulated by the decline in trade costs and by general improvement of the incentives regime. Finally, an increase in the rate of accumulation of certain factors of production (knowledge, human capital) may occur.

Table 3. Measures of Change in Integration

	Change in *Institutional Investors* rating (1983-85 to 1993-95)	Change in ratio of FDI to GDP (1980-82 to 1990-92)
Egypt	-0.7 (35)	-0.04 (0.57)
High income countries	0.21 (81.8)	0.02 (0.32)
East Asia	-0.05 (56)	0.03 (0.12)
Latin America	0.21 (40.1)	0.01 (0.32)
MENA	-0.39 (39.2)	0.0 (0.26)
South Asia	-0.08 (25.9)	0.0 (0.0)
Sub-Saharan Africa	-0.03 (18.5)	0.0 (0.11)

Note: Figures in parentheses are the relevant levels in early 1980s that are the base from which changes are calculated.
Source: World Bank, *Global Economic Prospects*, 1996.

While little empirical evidence exists on the long-term growth effects of preferential liberalization, much is likely to depend on the extent to which an inflow of FDI is induced. The experiences of Portugal and Spain following accession to the European Community illustrate the possibility of significant medium-term investment effects if the macroeconomic environment is suitable. FDI in Portugal rose fourfold during the mid-1980s, while in Spain it more than doubled. In both countries, FDI centered on the finance, real estate and business service sectors, as well as on more traditional export-oriented sectors (such as textiles and clothing).[v]

To what extent will a partnership agreement improve the incentives to invest in Egypt? The partnership agreement can be useful in generating greater investment by influencing expectations and enhancing the credibility of reform by locking in the right of establishment. Granting a general right of establishment and guaranteeing national treatment would be an important signal in terms of improving the investment climate. But other impediments, such as the cost of financial intermediation, the tax burden, and regulatory regimes, must also be addressed. It must also be recognized that a preferential trade agreement with the EU creates offsetting incentive effects for investment. On the one hand, the reduction in trade costs and the enhancement of competition will make the economy more efficient, and increase the trade of goods and services, providing investors with greater opportunities to exploit geographical and other advantages. On the other hand, the reduction in trade barriers reduces the incentive for inward FDI. As tariffs and other barriers to imports are eliminated, European firms no longer have a policy-induced reason to produce in Egypt. The greater the economies of scale in production, the greater the incentive may be to concentrate production in an EU location where a firm has access to many complementary service providers. The fact that a partnership agreement is simply a bilateral free-trade agreement worsens matters, as locating in an EU member (the "hub") gives duty-free access to all countries with which the EU has concluded free trade agreements—virtually all its neighbors (sometimes called "spokes"). As Egypt does not have comprehensive free trade agreements with all the countries in the region, and given the high transaction and transport costs that apply to intra-regional

[v] Bajo-Rubio and Sosvilla Rivero (1994), in an econometric analysis of the Spanish case, find a positive relationship between EU accession and FDI inflows.

trade, firms that rely on imported inputs and export a significant part of their output confront a cost in locating in Egypt.

One implication of this is that it is very important that trade barriers are lowered with as many countries as possible, and with neighboring countries in particular. Another implication is that opening up the service sector to foreign direct investors is important. Many services cannot be traded across frontiers, so the investment diversion incentives do not prevail. Foreign providers wishing to sell services in Egypt will generally have to establish a local presence. As efficient services are also an important dimension of raising the productivity of the economy, encouraging such investment should be a priority.

Improvements in TFP growth are another source of dynamic gains, which are likely to follow from the adjustment of domestic enterprises to the opening of the economy. Historically, Egypt has achieved relatively high rates of TFP growth, averaging around 2 percent over the 1960-90 period (Page and Underwood, 1996). More recently, however, TFP growth has been much lower, averaging 0.3 percent during 1982-92 (World Bank, 1994). The agreement with the EU may help boost TFP growth by facilitating the acquisition of technology. This may occur through a number of avenues: investments in new capital equipment as tariffs are eliminated; new inflows of FDI; technology licensing agreements (which may be stimulated in part through the adoption of stronger intellectual property protection); and more informal transfers of technology and know-how as linkages between European and Arab firms are facilitated. The last avenue may in part be attained through greater use of outsourcing arrangements, where goods are processed in Egypt and reexported to the EU. This has been an important avenue of export growth for Central and Eastern European countries. Of the countries of the Middle East and North Africa, only Morocco and Tunisia have begun to exploit this export development channel. Egypt appears to make almost no use of such mechanisms (Hoekman, 1996). The reduction in administrative red tape and transaction costs that should emerge as the agreement is implemented should increase the ability of enterprises to pursue such contracting.

The strategy taken towards tariff liberalization will also affect investment incentives. In the Tunisian approach, tariffs on intermediates and capital goods are reduced first, and reductions in final goods are delayed until the second half of the transition period. An advantage of this approach is that it provides domestic industry

with breathing space, and at the margin may provide greater incentives to invest in industries that continue to have guaranteed protection during the first phase of the transition. Thus, it may offset the possible downside related to the welfare cost of increasing effective rates of protection in the first part of the transition (Hoekman and Djankov, 1996).

III. 3 Domestic competition

The partnership agreement contains a number of provisions that are intended to foster greater competition on the Egyptian domestic market and to ensure that foreign firms are not discriminated against. These include antitrust disciplines for private parties (enterprises), competition policy rules for SOEs, restrictions on the reach and extent of industry-specific subsidies, and intellectual property right (IPR) protection.

The Tunisian partnership agreement requires the adoption of the basic competition rules of the EU, in particular with respect to collusive behavior, abuse of dominant position, and competition-distorting state aid insofar as these affect trade between the EU and Egypt. Implementing rules are to be adopted by the Association Council within five years (as opposed to three under the Europe Agreements). Until then, GATT rules with respect to countervailing of subsidies will apply. If the same approach is followed as in the agreement between the EU and Tunisia, for the first five years after entry into force of the partnership agreement, Egypt will not be subject to the rules on state aids (subsidies). Antidumping rules remain applicable to trade flows between Egypt and the EU, despite the agreement by Egypt to apply EU competition disciplines. In addition to the various provisions imposing concrete competition disciplines, the partnership agreement contains language pertaining to harmonization/coordination of regulatory regimes.

Compared to the impact of eliminating tariffs on EU industrial products, these provisions are likely to have a much smaller impact on domestic competition. More important than the disciplines that are incurred is what has been left off the agenda (at least in the cases of Tunisia and Morocco). The issue of granting and guaranteeing the right of establishment was already mentioned; at the time of writing it appeared that the agreement between the EU and Egypt did not include commitments in this area. Service-related bottlenecks can prohibit manufacturing or food-processing industries from exploiting their comparative advantage. Stimulating competition and providing

industries and traders with access to lower-cost, higher-quality services are therefore of great importance. Numerous studies have illustrated the drag on efficient production and export expansion imposed by high service and transactions costs in Egypt. These include excessive insurance fees, high port service costs, losses caused by unnecessary waste and breakage of goods due to low quality transport and storage, and unavailability or excessive costs of value-added telecommunications services (World Bank, 1994; 1995a,b). Allowing entry into service activities should help offset these various costs. Although the government may not be willing to open all services to foreign competition, it may wish to consider liberalizing access to a number of major sectors where foreign investment is likely to materialize. Examples include trade and distribution, business and professional services, and telecommunications. In some of these sectors the large investment required to improve output (both quantity and quality) will probably require private participation.[^]

IV. How Will the Agreement Affect Agriculture, Industry and Services, and thus Growth?

What does the partnership agreement imply for individual sectors? What will it do in terms of inducing enterprises to improve productivity and adopt best practices? Clearly, more competition will allow some industries to expand, and cause others to contract. This process of reallocating resources to their most efficient uses is fundamental to enhancing economic growth. It is of course difficult to predict how specific sectors will be affected, as much depends not only on industry-specific initial conditions but also on the flexibility of the labor market and on the investment response by the private sector. However, data on current patterns of protection, import penetration and export sales on a sectoral basis provide some information on the possible impact of the agreement.

Overall, the absence of significant liberalization of agriculture by the EU, and the lack of immediate action on services by Egypt implies that most of the policy changes will impact primarily on manufacturing. Moreover, it can be argued that the lack of free trade in agricultural produce significantly reduces the benefits of a partnership agreement for Egypt. Agriculture is an important sector of the Egyptian economy, accounting for almost 20 percent of GDP and over 35 percent of employment.

[^] Despite the importance of the role of the state in economic activity and competition, no real disciplines are imposed under the partnership agreement with respect to the role of the state.

Vegetables and fruits dominate Egypt's exports of agricultural produce, standing at $200 million in 1994, of which 40 percent went to the EU. However, agriculture accounts for less than 5 percent of total exports (Egyptian agricultural exports account for less than 0.08 percent of total EU imports of such products). Also, many of Egypt's major agricultural import items do not originate in the EU. Only 13 percent of Egypt's $870 million of cereal imports came from the EU, and only 7 percent of the $277 million of vegetable fat imports. Egypt will not lower tariffs on these items, which reduces the potential for trade diversion. It also provides Egypt with some negotiating leverage, which the Egyptian negotiating team has made efforts to employ. What will be achieved in this connection remains to be seen. Beyond the immediate impact of the agreement, both agriculture and the service sector will be affected indirectly, as relative prices of factors and goods and services change. The absence of agricultural liberalization by Egypt implies that the effective rate of protection (ERP) for agriculture rises over time. This is because farmers benefit from cheaper manufactured inputs into their production process (fertilizers, equipment, etc.). Indeed, currently agriculture is effectively taxed (Table 4). As tariffs on industrial goods are gradually reduced, the ERP for agriculture rises above zero, and greater value added is generated. A similar effect occurs for services. Even if allowance is made for the fact that services are protected because of entry restrictions, service activities are currently effectively taxed because the average level of import protection applying to manufactures is substantial. As tariffs are lowered, the ERP for service sectors rises. Agriculture and services therefore benefit from the reduction in trade barriers on manufactured goods. Indeed, for many service sectors ERPs may rise significantly. This implies that there is a need for reducing barriers to competition in services that goes beyond the noted need for efficient services. Without policies to reduce ERPs in services, investment incentives may become skewed (Table 4).

With respect to manufacturing, data on trade openness and levels of protection are helpful in identifying the adjustment pressures that are likely to emerge for different sectors. Industries benefiting from high levels of protection, with low imports as a share of domestic consumption and/or limited exports as a share of output, are the most likely to confront significant adjustment pressure. Examples of such sectors include clothing, leather, footwear and furniture (Table 4). Much depends on the

export capacity of the industry involved. The greater the export share of an industry, the more efficient it is likely to be, as this is a condition for contesting world markets.

Table 4. Protection and Trade Shares 1994

Sector	Nominal Tariff	ERP[(1)]	ERP [(2)] Year 2010	Imports/Apparent consumption	Exports/ Domestic output
Agriculture				%	%
1. Vegetable Foodstuffs	2.5	-5	4	18.3	2.3
2. Other vegetable products	6.7	-5	8	0.4	0.7
3. Animal products	4.4	18	64	2.0	0.4
Mining and Quarrying					
4. Oil	8.2	-21	-29	31.1	79.0
5. Other	7.0	-5	-10	31.0	2.1
Manufacturing					
6. Food processing	6.8	59	-11	29.1	1.9
7. Cotton ginning	17.3	9	-23	12.2	40.9
8. Cotton spinning/weaving	23.3	38	-24	10.9	22.7
9. Clothing	53.7	147	77	0.3	9.6
10. Leather	34.8	13	-22	1.5	5.7
11. Shoes	51.8	267	33	1.1	0.1
12. Wood products	8.1	54	-20	48.8	0.7
13. Furniture	46.9	107	-10	0.2	4.2
14. Paper & printing	13.3	52	-29	32.5	6.9
15. Chemicals	8.9	-12	-64	43.2	6.7
16. Petroleum refining	7.1	45	-25	9.4	13.8
17. Rubber/plastic	15.6	16	-10	38.7	4.9
18. Ceramics	43.5	98	36	23.9	3.9
19. Glass	29.6	91	4	25.7	4.7
20. Mineral products	18.1	21	-10	4.7	0.1
21. Iron, steel	17.2	9	2	16.8	3.3
22. Machinery	17.9	20	-28	61.3	15.0
23. Transport equipment	41.2	65	-20	55.3	4.6
24. Other	19.3	23	-8	45.4	9.6
Manufacturing average		51	-9		
Services					
25. Construction		-64	58		
26. Electricity, gas		-116	-45		
27. Transport, storage		-25	43		
28. Hotels, restaurants		-42	20		
29. Communications		-15	25		
30. Finance		-10	11		
31. Distribution		-9	8		
32. Insurance		-4	5		
Services average		-36	16		

1) Effective rate of protection in 1994, including an assumed 15% tariff equivalent for services.
2) Assumes full implementation of the partnership agreement but no reduction in service tariff equivalents.
Source: Konan and Maskus (1996) and Hoekman and Djankov (1996).

Although imports of clothing will increase substantially following the decline of quantitative restrictions, segments of the domestic industry are already exporting

substantially, and the industry should be able to maintain its current output (Konan and Maskus, 1996). Moreover, the ERP for this industry remains high even after full implementation of the agreement. The leather, paper and printing, chemicals and machinery industries also have significant export sales, and should therefore find it easier to adjust to a more competitive domestic environment. Most of these industries also confront substantial import competition. Other industries already subject to import competition include food processing, wood products, rubber and plastics, ceramics and glass, and transport equipment. However, in some instances this comprises components or inputs that are processed/assembled in Egypt. As tariffs on the final goods involved are lowered, the incentive to engage in such processing will decline; this is particularly likely to be seen in the motor vehicle sector, which consists of assembly operations.

A useful measure of the impact of the agreement on individual industries is the magnitude of the change in effective protection. The greatest absolute declines will occur for footwear, ceramics, furniture, glass and glass products, paper and printing, transportation equipment, clothing and food processing (in that order). However, of these sectors, footwear, ceramics, and clothing will continue to benefit from relatively high ERPs at the end of the 12-year transition to free trade with the EU. In contrast, furniture, paper and printing and transportation equipment—which all have high ERPs at the present—will end up with negative effective protection. It can also be observed that the dispersion in protection across sectors continues to be high, both within manufacturing, and as noted earlier, between manufacturing and the services sectors.

In other words, the partnership agreement will contribute to opening the Egyptian economy, reducing transaction costs, subjecting domestic firms to greater competition, and possibly attracting more FDI. The negotiator can strive for a better agreement for Egypt, and the government can help viable industries in the adjustment process. More important perhaps, the government can adopt other complementary policies at home to maximize the gains from the agreement.

V. Policy Reforms to Take Full Advantage of the Agreement

Egypt has the potential to join the club of fast-growing economies. It has the human capital, an advantageous geographical location, and a diversified industrial base. As

noted previously, significant progress has been made on macro-economic variables. Being a poor economy also helps. Poorer economies can expect to grow faster than richer countries because of lower capital-labor ratios and higher rates of return on new investments, both of which attract investment, and because poorer countries can take advantage of technological advances already made by the richer countries.

Convergence tendencies, however, are not automatic. Much depends on whether policy makers adopt appropriate economic policies and institutions. Before looking at what the Egyptian policy makers could do to capitalize on and complement the partnership agreement in the medium term, it is useful to consider the savings-investment possibilities in Egypt in the short run.

V.1 Savings and investment in the short run

We start with the assumption that Egypt should grow by at least 7 percent annually. This requires three things: (1) boosting the investment rate from about 17 percent of GDP to 27 percent, and securing corresponding increases in savings—domestic and foreign—to finance it, (2) allocating resources to their most efficient uses, and (3) invigorating the efficiency of the capital stock, current and new. All this must be achieved without compromising financial stability.

All told, there is some room for mobilizing additional savings in the short run, mainly from privatization of SOEs and attracting more FDI. However, mobilizing savings and investment to levels comparable to those of the fast-growing Southeast Asian economies is out of reach in the short run. For Egypt to make the quantum shift necessary to achieve a sustainable rate of growth of 7 percent, a significant shift in orientation is necessary. Higher domestic savings can come from the government sector, the SOE sector, or the private sector. Experience has shown that the response of private sector savings is both uncertain in magnitude and duration, and generally follows growth. Greater government savings will require higher taxes or lower expenditure. Higher taxes would be inconsistent with efforts to induce investment, while the room for reducing government expenditure is narrow, given that real wages of the civil service have already been eroded and unemployment in the country is high. In addition, the budget will, in any event, lose revenue from tariff cuts. Accordingly, the scope for higher government savings in the short run is limited. This leaves the SOE sector as the main potential source of higher domestic savings. Additional

savings from privatization, liquidation of loss-making companies, and reforming the remaining SOEs would amount to some 2 percentage points of GDP.[9] But the privatization process is universally slow, and such savings will take time to materialize.

Investment minus domestic savings equals the current account. A current account deficit can by financed by: (i) running down reserves, (ii) borrowing more from abroad, or (iii) attracting more foreign direct investment. Egypt's reserves are currently at US$ 18 billion, equal to 18 months' import cover. A target of 12 months' cover would allow for room to run down reserves to about US$ 15 billion (which could be the average import level as growth picks up). But this can only provide a one-off source of savings (of, say, 4-5 percent of GDP). Borrowing from abroad, though feasible to some degree, would add to the debt service burden in the future (the current level of foreign debt is about US$ 32 billion, or 60 percent of GDP). This leaves FDI as the most likely candidate for providing additional savings in the short run. Of the 10-percentage point increase in aggregate investment needed to boost growth, about half would have to be financed by FDI. This would amount to about LE10 billion or US$2.9 billion in annual inflows of FDI, which is several times the current inflow. The policy effort required to attract such flows is considerable and unlikely to be feasible in the short run.

V.2 Complementary policies to achieve high sustainable growth in the medium run

How then can Egypt make the desirable quantum shift in policies to achieve the rapid and sustainable growth achieved by the fast-growing countries? To reiterate, Egypt is in a good position to adopt such reforms. It has a stable policy environment and financial stability (inflation is less than 10 percent; reserves are significant). The key problems are that the size of the government is too large to induce savings; markets are too closed to promote exports of manufactured goods; and domestic competition is impeded further by the dominance of SOEs. The partnership agreement with the EU will help somewhat in relaxing some of these constraints, but significant changes that go beyond the agreement are needed to move ahead.

[9] This is a conservative estimate, and is based on a simulation carried out for India. (See World Bank, 1996).

Savings, investment and size of government. Perhaps the most important disincentive to greater savings and investment is the size of the public sector. The role of the state in Egypt is pervasive. As noted already, government expenditure is 36 percent, compared to 21 percent in the fast-growing economies. The size of the SOE sector relative to GDP is 33 percent, compared with the world average for developing economies of 11 percent (World Bank, 1995d). Not surprisingly, domestic savings are about half the average for the fast-growing economies. To increase domestic savings, there is no way but to reduce the size of government expenditure and taxes, as well as the size of the SOE sector.

Lower taxes would not only increase savings, it would also help to increase investment. A necessary condition is that the environment is conducive. To improve the environment, there is a need for simplifying and unifying the investment law. This simplification, however, should not be pursued by giving multiple and distorting incentives for all variety of reasons that are hard to implement fairly, as envisaged in the current draft company law (or investment law). Rather, it should be pursued by further reduction and unification of corporate tax rates, and providing infrastructure in new industrial geographical locations deserving promotion, to address the problem of congestion in large cities. Inducing investment could also be pursued effectively by tax administration reform, with a view to reducing discretion in implementation. To partially offset the reductions in corporate tax rates, effort should be made to modernize the tax system and move quickly on VAT to widen the tax base. In the process of restructuring taxes and expenditure, effort should be made to spend less on re-distributive transfers and more on primary education, health and infrastructure projects not undertaken by the private sector.

The gradual reduction of tariffs that will be implemented under the partnership agreement will result in a reduction in the effective level of taxation and a fall in government revenues (assuming away any offsetting revenue effects resulting from greater economic activity). Here, the government has two choices: (1) seek to replace the lost tariff revenue through the imposition of alternative indirect taxes (such as GST or a future VAT), or (2) reduce expenditures in line with the gradual fall in tariff revenue. In our view, the latter option is in the best interests of the economy from a growth perspective. Tariff revenue from the EU in 1994 was $800 million. Taking into account that EU import market share will expand, the revenue loss at the end of

the transition is likely to be on the order of $1.0 billion, or 2 percent of GDP. This is not negligible, but alternative sources of savings (income) are readily available, privatization being the most important.

Openness and manufactured exports. As mentioned before, Egypt's tariffs are high; the collected average being more than double that of many fast-growing economies. Efficiency gains as well as the shift of resources into export sectors require a gradual pre-announced lowering of tariffs on goods that originate in non-EU countries in order to expose domestic firms to international competition. Free zones, tax holidays, and other selective types of liberalization will not help. The objective must be—taking into account the constraints—to convert the whole country into a free zone or something close to one. More uniform tariffs and tariff reductions must be introduced, given the evolving regional environment and the imminent conclusion of the partnership negotiations with the EU.

A significant reduction in MFN tariffs will reduce potential trade diversion induced by the partnership agreement, subject industries to greater competition and thus induce efficiency-enhancing measures. Simulation models show that there are opportunity costs associated with preferential liberalization. For example, Konan and Maskus (1996) conclude that if Egypt were to extend free trade to the world, welfare would increase by 2.6 percent of GDP. Alternatively, if a uniform, nondiscriminatory tariff of 10 percent were imposed, welfare would rise by 2.3 percent. This illustrates the gains that can be obtained by extending the partnership agreement gradually over time to the rest of the world.

Reducing hub-and-spoke investment diversion incentives is also important, otherwise a free trade agreement may create incentives for firms not to invest in Egypt but to locate in the center (hub) of the network of EU trade agreements (i.e., Europe). Trade barriers against regional trading partners should be eliminated as rapidly as possible to encourage investment by domestic and foreign firms that are interested in servicing regional markets and want to benefit from Egypt's geographical location and relatively diversified industrial base. The government is cognizant of this issue and has initiated talks with neighboring Arab countries to agree on common rules of origin. It is necessary to go beyond this and pursue regional free trade.

With respect to the exchange rate, it may have been wise to use the rate as a nominal anchor of reform to curb inflation in the early stages of the economic reform program. However, the current policy is not sustainable in the medium run. Accumulated appreciation will eventually reduce the competitiveness of exports, and encourage consumption by increasing imports, thus lowering domestic savings, investment and growth. Moreover, as the economy approaches fuller employment, fixing the exchange rate means that domestic prices will rise, which will give rise to further real exchange rate appreciation. The cost of deferring devaluation and adoption of a more flexible exchange rate policy can be very high. Cardoso (1996) illustrates the dire consequences of flawed exchange rate policy by citing the Chilean crisis in the late seventies and early eighties (where GDP dropped by 14 percent) and the 1994 Mexican crisis (where GDP dropped by 8 percent). Egypt should not travel that path. The exchange rate issue should be addressed sooner rather than later, especially since delay would make it harder to adjust. The government could gradually move from a fixed exchange rate regime to a crawling peg regime, whereby the Egyptian pound is linked to a set of hard currencies. This type of reform has recently been adopted by countries such as the Czech Republic.

Competition and private sector-led growth. The partnership agreement with the EU will progressively increase the competitive pressure on industrial producers through trade liberalization. However, with the size of the SOE sector in Egypt being three times the average of developing countries, competition will almost always be compromised. To enhance competition, privatization of at least two thirds of the current SOE sector enterprises should be pursued. Privatization will increase the efficiency of utilizing existing capital stock and arrest the flow of resources to unviable enterprises (both of which would increase savings). It would also signal the withdrawal of government from certain sectors of economic activity. Equally important, privatization would increase private investment and attract FDI.

While the sale of the companies already trading on the stock market may serve as a start, attracting FDI requires a "landmark" privatization. In other words, privatization would have to be widened to encompass infrastructure, particularly telecommunications and port services (which would help improve the efficiency of

exports). The sale itself can be conditioned upon commitment to expand on the part of the buyers, as happened in Chile and Mexico.

For privatization to be successful in enhancing domestic savings and attracting foreign investment, two main conditions have to be met. First, privatization in infrastructure should be preceded by introducing competition in potentially competitive markets, unbundling existing companies, adopting appropriate regulatory rules (for example, with respect to prices and interconnection) and creating genuinely independent regulatory bodies. Second, the revenue from privatization should be used to retire public debt. This will relieve the government budget from the burden of servicing the debt, and thus enhance public savings.[10]

VI. Conclusions

The partnership agreement has the potential of playing a catalytic role in increasing the openness of the Egyptian economy, attracting FDI, and signaling the government's commitment to reform. The agreement is a tool, not an end in itself. It must be used to help achieve what Egypt needs most: a high rate of economic growth. This will not be achieved through the partnership agreement alone; rather, the partnership agreement should be just one (albeit important) component of a broader growth strategy. To reduce uncertainty it is crucial that the long-term policy path is spelled out clearly and debated publicly.

Increasing savings and investment in productive activities is key in the medium term. For this, Egypt should increase public sector savings (by reducing the size of the public sector) and reducing the tax burdens (by lowering tax rates and improving tax administration). In addition, a comprehensive privatization effort is crucial for fostering national savings (public and private), encouraging private sector investment and the repatriation of flight capital. Greater openness and exchange rate reforms are also essential for fostering savings and domestic competition and promoting manufactured exports.

The partnership agreement will help in encouraging investment and improving the allocation of resources. The impact and usefulness of the partnership agreement will be greatest if its reach extends to investment (guaranteeing the right of establishment)

[10] The proceeds should not be used to restructure public enterprises, save the necessary cost of facilitating privatization (e.g., labor compensation).

and the liberalization of service markets. The right of establishment is critical for capital inflows. Liberalization of services is required to enhance domestic competition, expand investment opportunities, and provide domestic manufacturers with the low-cost, high-quality producer services they need in order to be able to compete on world markets.

Preferential liberalization is in principle a suboptimal approach to reducing trade barriers, as it gives rise to trade diversion. The greater the elimination of transaction costs in the context of the partnership agreement, and the more liberalization is generalized to all trading partners over time, the more such diversion will be offset. This implies a leveraging of the partnership agreement. Simulation studies—of both Egypt and other countries in the region—show that the adjustment costs of a nondiscriminatory approach to liberalization are not significantly higher than what will be incurred under the partnership agreement. However, the additional gains are substantial.

Last but not least, the set of recommended policy reforms should be designed and pursued in a credible, comprehensive and consistent fashion to be successful. The policy initiatives have to be *credible* to evoke a sustained investor response (especially from foreign investors) and overcome cynicism bred by years of patchy implementation and wavering commitment. They have to be *comprehensive* to have their full impact and signal that the effort is not selective and piecemeal. Finally, they have to be *consistent* to ensure that they can be implemented without being derailed by internal contradictions.

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